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Dear Sirs,

Reform of the close company loans to participators rules

I am writing to you on behalf of the British Private Equity and Venture Capital Association (the "**BVCA**"), which represents the interests of members of the private equity and venture capital industry. The BVCA is the industry body and public body advocate for the private equity and venture capital industry in the UK. More than 500 firms make up the BVCA members, including over 250 private equity, mid-market, venture capital firms and angel investors, together with over 250 professional advisory firms, including legal, accounting, regulatory and tax advisers, corporate financiers, due diligence professionals, environmental advisers, transaction services providers, and placement agents. Additional members include international investors and funds-of-funds, secondary purchasers, university teams and academics and fellow national private equity and venture capital associations globally.

This letter has been formulated by the BVCA's Taxation Committee, whose remit is to represent the interests of members of the industry in taxation matters. The BVCA welcomes the opportunity to submit formally its comments on the consultation document entitled "Reform of company loans to participators rules" released by HMRC on 9 July 2013 (the "**Consultation**") and how it might affect members of our industry. Our comments in respect of the Consultation are set out below.

Application of the current loans to participators rules to the private equity industry

The objective of loans to participators rules is set out in the Explanatory Notes to clause 70 of the Finance Bill 1965:

> "1. [The loans to participators rules are] directed against an avoidance device under which a close company would make loans to its shareholders instead of paying them dividends. Dividends would be liable to income tax, and to surtax in the hands of shareholders who were surtaxpayers; but apart from this clause loans would not be liable to income tax or surtax even though they were left outstanding indefinitely or were eventually waived. The clause requires a close company to pay income tax

when it makes a loan to a participator (or to one of his associates) just as though it had paid a dividend, the income tax is repayable if the loan is repaid to the company."

It is important to note that the relevant company will only be required to pay the tax charge if it is a close company - the issue being that the shareholders in a close company may permit the company directors to arrange loans on terms which would not be acceptable if the shareholder base were more diverse.

The definition of a close company in the context of the loans to participators rules has a specific and disproportionate impact on the private equity and venture capital industry due to the way in which private equity funds are structured.

A private equity fund is typically arranged as a limited partnership whereby the investors in the fund each acquire a limited partnership interest in the fund in proportion to the size of their investment. The fund itself is controlled by a 'general partner' which is typically a company which itself is a close company. The fact that the fund is controlled by the general partner which itself is close frequently results in companies in which the fund acquires a significant stake (a 'portfolio company') falling within the definition of a close company.

However, in any event, under the definition of "control" in s.450 CTA 2010, where members of a partnership together hold an interest in a company those partners are considered associated with one another for the purposes of determining whether they together exercise control over that company. In effect, this results in a partnership being treated as a single entity and therefore constituting one of the five or fewer participators under the close company test in s.439. This is the case even though the partnership may have a large number of individual partners that are otherwise not connected with each other.

In this context the legislation fails to take into account the diverse nature of investors in a typical private equity fund. Such investors can include large listed companies, insurance businesses, pension funds, sovereign wealth funds and private individuals. Further, the fund managers are accountable to the fund investors both under the documentation regulating the fund and in the market.

As such, although the investors in a fund may be extremely diverse, by virtue of the fact that the fund is controlled by the general partner and, as partners in the fund, the investors are associated with one another, the portfolio company into which the fund invests may be a close company. This result is at odds with the reality that the beneficial ownership of the portfolio company is broad - the diverse investor base of a PE fund is such that if each of the limited partner investors were to invest directly into the portfolio company it is unlikely that it would be a close company.

In our view this is an anomaly which causes the majority of private equity portfolio companies to be close companies for tax purposes by accident of the typical fund structure widely adopted in the private equity industry rather than being a 'true' close company within the intent of the legislation.

We therefore suggest that HMRC takes the opportunity of the current Consultation to amend the definition of a close company in the context of loans to participators to exempt a portfolio company where the company is close either by virtue of it being controlled by a private equity or venture capital fund or where it is considered close only by virtue of including the private equity or venture capital fund as one of the five or fewer participators for the purposes of s.439(2)(a) CTA 2010.

For these purposes it may be most straightforward to draft the exemption by reference to a 'collective investment scheme' as defined in s.235 of FSMA 2000.

Practical examples of impact of the current rules

As noted above, by accident of the typical private equity fund structure, the portfolio companies in which such funds invest frequently fall within the definition of a close company. This can have adverse practical implications. For example:

1. Portfolio companies frequently establish employee benefit trusts in order to motivate and retain employees. In order to fund the employee benefit trust the portfolio company may wish to lend cash to EBT. Where the EBT is already a participator in the portfolio company and the portfolio company is a close company, the loan may be subject to the 25% tax charge if it is not repaid within the appropriate time period.

2. Under the current legislation where a close company controls a group, each of the subsidiary companies within that corporate group would also be considered close. An upstream loan made by a subsidiary company to its immediate parent would therefore be caught by the rules - it is unclear on what basis the loan should give rise to a tax charge in this scenario. We are aware that in many cases the potential for a tax charge in the context of an upstream loan is not always recognised and as a result has given rise to due diligence issues on a transaction which inevitably gives rise to delays and additional costs.

3. Executives involved in the management of a portfolio company are frequently required to invest some of their own cash into the business to demonstrate commitment to the business model and alignment with the private equity investors. On occasion the executive will not have sufficient funds to invest in which case it may be necessary for the executive to be loaned the cash. It is frequently the case that the loan cannot be made by the PE fund that is backing the investment due to restrictions within the terms of the fund or finance agreements and such a loan potentially falling under the provisions of Part 7A ITEPA. An alternative would be to establish a new entity to make the loan but this typically incurs administrative costs that are disproportionate to the amount of the loan and such a loan may similarly fall under Part 7A.

   A loan from the holding company in which the executive is or will become a participator is therefore often adopted. This route can result in a tax charge to the lending company under the loans to participators rules, but also potential income tax for the borrower under the benefit in kind rules and income tax if the principal of the loan is written off. The tax result in this context runs counter to the current emphasis of the Department for Business, Innovation and Skills on encouraging greater employee ownership.

Each of the examples above illustrates a scenario in which the loans to participators rules impose a tax charge on a loan that is not intended to be the transfer of value as envisaged by the original rules.

Options 3 and 4

We do not share HMRC's view at paragraph 3.17 of the Consultation that a fairer tax system would reflect the period for which the loan is outstanding and how long the participator has use of the company's money. In our view this statement does not reflect the intention of the loans to participators legislation which is to prevent the disguising of a dividend as a loan and

to ensure that if a loan is provided to a shareholder rather than a dividend, the amount of tax paid is the same as if a dividend had been paid. Given this background the length of time for which the loan is outstanding should not matter. On this basis we do not agree with the imposition of annual charges described in options 3 and 4.

Further, under current legislation there can be a charge under the loans to participators rules as well as a benefit in kind charge in respect of the loan (together with the potential for tax under the disguised remuneration rules in Part 7A ITEPA). The existence of annual charges in the hands of employees in respect of outstanding loans should mitigate the need to impose an annual charge on the lending company. It therefore seems unnecessary to amend the loans to participators rules to introduce annual charges when such charges are already imposed elsewhere in the tax legislation.

For these reasons we would not support the amendments proposed in options 3 and 4.

Preferred approach

When originally enacted the loans to participators rules were designed to tax disguised dividends and thereby prevent the extraction of cash from a company which should have been treated as a dividend.

This objective was achieved by aligning the tax rate that the recipient of the loan would incur were the funds to be distributed by way of dividend with the corporate tax rate imposed on the company in respect of the quantum of the loan.

However, due to increases in the income tax rate to a top marginal rate of 45%, the dividend tax rate has risen to 30.6% (after tax credit) – above the 25% rate currently imposed.

As noted above, our preferred approach would be to amend the current loans to participators rules to provide an exemption for companies that are close only by virtue of private equity control. However, given the wider context of the loans to participators rules and in order to realign the existing rules with the original intention of the legislation, we suggest that the applicable corporation tax rate for a loan that is not repaid within 9 months of the accounting period in which it is made is increased to 30% or some calculation that automatically adjusts with changes to rates of tax.

As is the case under existing law, where the loan is repaid or written off we would expect the corporation tax incurred should be refunded to the company.

We would welcome the opportunity to comment on any draft legislation and to attend further meetings with HMRC in respect of the Consultation. If you have any questions in relation to our responses set out in this letter, please do not hesitate to contact me on 020 7389 6431 or Steven.Whitaker@VisionCapital.com.

Yours faithfully,

Steven Whitaker

Chairman of the BVCA Taxation Committee